

Pakistan

Growth picked up slightly, but for the fifth consecutive year low growth, falling investment, excessive fiscal deficits, high inflation, and a deteriorating external position weighed on the economy. While problematic security and natural disasters are endemic, a difficult political situation stalled effective policy response to macroeconomic and structural problems, especially regarding energy. As official reserves are steadily declining on low capital inflows and heavy debt repayments, downside risks color the outlook.

Economic assessment

Economic performance during the first half of FY2012 (ended June 2012) was driven by a rebound from the devastating floods a year earlier that was partly offset by record power outages from load shedding in the second half. Growth strengthened to 3.7% but again remained well below the 7% pace needed to absorb new workforce entrants (Figure 3.20.1).

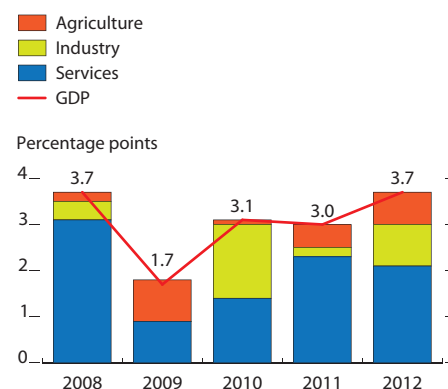
Agriculture recovered to grow by 3.1%, as better weather favored the production of major crops, though minor crops in parts of the country were hurt by floods. Industry expanded by 3.4%, mainly from post-flood reconstruction. The impact of the higher load shedding was apparent as large-scale manufacturing reversed early gains, tapering off to 1.2% expansion for the year, even lower than the flood-induced slowdown to 1.8% in FY2011. Output of intermediate goods declined for the third year in a row as Pakistan's steel, petroleum refining, and fertilizer industries continue to operate well below capacity. The large service sector, growing by 4.0%, continued to account for most GDP expansion.

Private consumption expenditure expanded by 11.6% in FY2012 to provide nearly all GDP growth (Figure 3.20.2). As in past years, it benefited from rising remittances and government salary increases. Fixed investment fell for the fourth year in a row, to 10.9% of GDP, the lowest share since 1974 and the lowest among major Asian countries (Figure 3.20.3). This downdraft is being driven by prevailing security issues, worsening power shortages, and growing concern over the general direction and outlook for the economy.

Clearly, the steady decline in investment, coupled with reliance on consumption for growth, is unsustainable and undermines future growth prospects. Investment subtracted 1.4 percentage points from growth in FY2012. Net exports subtracted 3.8 percentage points partly because energy outages frustrated producers efforts to reliably meet export schedules and partly because demand was slack from the global slowdown.

Food inflation eased in FY2012, allowing consumer price inflation to slow from the 13.7% average pace of FY2011 to 11.0% in FY2012.

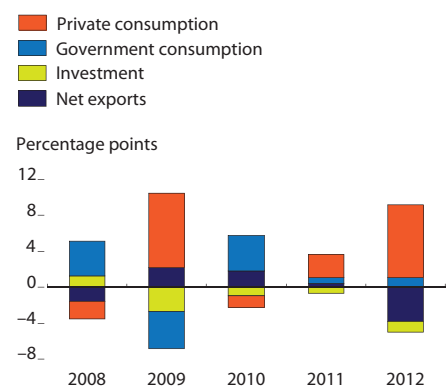
3.20.1 Supply-side contributions to growth



Source: Ministry of Finance. *Pakistan Economic Survey 2011–12*. <http://www.finance.gov.pk>

[Click here for figure data](#)

3.20.2 Demand-side contributions to growth



Source: Ministry of Finance. *Pakistan Economic Survey 2011–12*. <http://www.finance.gov.pk>

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The persistence of inflation in nonfood components is evident in the observation that core inflation measures, which exclude food and energy, accelerated from 9.5% at the beginning of FY2012 to 11.4% by June 2012, as more items in the basket experienced double-digit increases.

The FY2012 budget deficit ballooned to 8.5% of GDP from 6.6% in the previous year, well above the 4% target (Figure 3.20.4). The bulk of the overrun was from recurrent outlays, mainly higher spending on power subsidies and funding to partly settle power sector arrears. Interest payments were also over budget, increasing to 4.0% of GDP and 42.2% of federal tax revenue, as domestic borrowing drove up the government's domestic debt by 27%.

Patterns from previous years continued, as outlays for wages and other expenses, pensions, subsidies, defense, and interest payments substantially exceeded federal tax revenues, leaving the government's current operations to be substantially financed through debt (Figure 3.20.5). Development expenditure, restricted by flooding in FY2011, bounced back and met its targeted 3.5% of GDP.

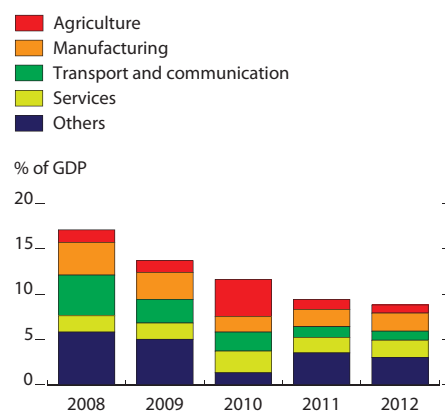
Tax revenues collected by the Federal Board of Revenue increased to 9.1% of GDP from 8.6% in FY2011 but still fell short of budget targets. The 20.8% growth in tax revenue reflected in part receipts from flood-related emergency measures, higher sales tax receipts on imports (particularly oil), and administrative improvements. There was also a significant shortfall on nontax revenues as Coalition Support Fund receipts and the auction of 3G mobile phone licenses were delayed. Collections under the petroleum development levy fell short as it was reduced to offset the impact of higher oil prices on consumers.

The magnitude of recent deficits worked against compliance with the Fiscal Responsibility and Debt Limitation Act, 2005. The provisions of the act called for a revenue surplus over current expenditure by FY2008 to ensure adequate capacity for public investment, doubling the share of spending allocated to health and education, and debt limits. While these goals appear distant at present, achieving them seemed feasible at the time, as FY2004–FY2007 fiscal deficits averaged a low 3.6% of GDP, there was near revenue balance, and foreign direct investment inflows to privatize state-owned enterprises were on the rise.

As external financing covered a scant 10% of the FY2012 deficit, the bulk of financing came from domestic markets, including PR\$505.7 billion in borrowing from the State Bank of Pakistan, the central bank. A legal restriction calling for borrowing from the central bank to be zero at the end of each quarter fell by the wayside. The 27% increase in government domestic debt was mostly in short-term issues that eroded the government debt maturity structure and heightened rollover risk.

Public debt expanded to PR\$1.6 trillion in FY2012, raising the ratio of government debt to GDP to 62.5% (Figure 3.20.6), which substantially exceeded the limit set under the Fiscal Responsibility and Debt Limitation Act. External public debt dropped from 27.6% of GDP to 25.6%, while domestic public debt including the debt of state-owned enterprises increased from 33.3% of GDP to 37.0%. Pakistan's debt is higher than the recommended 30%–40% of GDP for economies at a similar stage of development.

3.20.3 Gross fixed capital formation

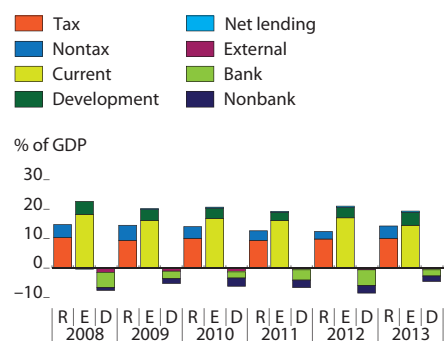


Note: Others include finance and insurance, electricity and gas, wholesale and retail, mining and quarrying, and ownership of dwellings.

Source: Ministry of Finance. *Pakistan Economic Survey 2011–12*. <http://www.finance.gov.pk>

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3.20.4 Fiscal performance



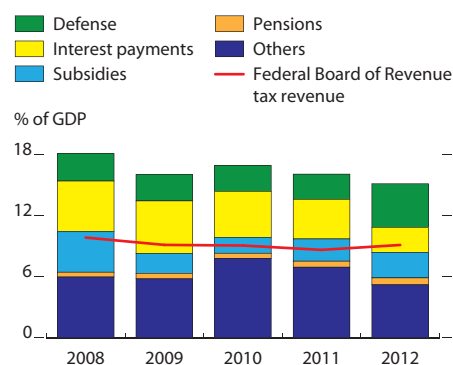
R = revenue, E = expenditure, D = deficit financing.

Notes: Data refer to consolidated federal and provincial governments. Net lending includes statistical discrepancy. Nonbank includes privatization proceeds.

Sources: Ministry of Finance. *Pakistan Economic Survey 2011–12*; *Pakistan Fiscal Operations July–June 2011–12*; *Federal Budget 2012–2013*, *Budget in Brief*; ADB estimates.

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3.20.5 Current revenue and expenditure



Sources: Ministry of Finance. *Pakistan Economic Survey 2010–11*; *Pakistan Fiscal Operations 2011–12*. www.finance.gov.pk

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The central bank policy stance in FY2012 was generally accommodative. As inflation eased early in the year, it lowered the policy rate by 200 basis points to 12% to stimulate investment and strengthen growth. However, surging deficits made government debt readily available and more attractive than lending to the private sector in a risky business environment, which inhibited commercial banks' financial intermediation. Bank loans to private businesses did increase by PRs18.3 billion, or 0.8%, but this amount was dwarfed by banks' PRs692 billion in lending to the government (Figure 3.20.7).

Broad money growth of 14.1% in FY2012 was somewhat slower than in the year earlier, largely reflecting the drawdown of foreign exchange reserves, ensuring that money growth came entirely through an expansion of net domestic assets. The loss of foreign exchange reserves, combined with the large amount of government debt entering the market, caused liquidity shortages at banks that were met by weekly injections by the central bank of up to PRs600 billion, far larger than in the past.

The current account returned to a deficit of 2.0% of GDP in FY2012, after a marginal surplus in FY2011 (Figure 3.20.8). The reversal came mainly from an 11.9% increase in imports, as oil payments increased by nearly 17% and fertilizer imports doubled because of shortages of natural gas. Exports contracted by 2.8%, as textile exports stagnated, cotton prices fell, and food exports declined. Remittances continued to grow at a robust 17.7% pace, somewhat slower than a year earlier, but still providing an important cushion for the trade account deficit.

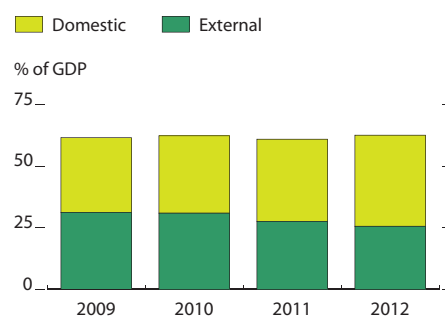
Inflows in the capital and financial accounts continued to decline, while debt amortization payments increased, reducing net liquid foreign exchange reserves by about one-quarter in FY2012, to \$10.8 billion, or 2.6 months of import cover. Foreign direct investment fell to \$821 million, and private portfolio investment recorded net outflow. Sustained inflation and pressure on the foreign exchange market induced a 9.1% depreciation of the Pakistan rupee against the US dollar.

Prospects

The end of the government's 5-year term in mid-March 2013 limited political scope for major policy or structural reforms. Economic developments in FY2013 are therefore unfolding along broadly similar lines as in FY2012 but with deepening concerns about sustainability and the adequacy of foreign reserves.

The economic situation weakened further in the first half of FY2013 as official reserves declined markedly, food and general inflation both reaccelerated in January following their earlier decline, and exports stagnated while imports contracted. Economic growth is expected to slow to 3.6% in FY2013, with risks on the downside from possible shortfalls in agricultural production, which may offset the modest improvement in large-scale manufacturing during the first half of the year. Production of petroleum products, iron, and steel picked up, but growth in textiles and food, which account for almost half of large-scale manufacturing production and the bulk of exports, remained negligible. Manufacturing performance for the year will hinge largely on limiting power outages during the hot season, when demand peaks. With little prospect for

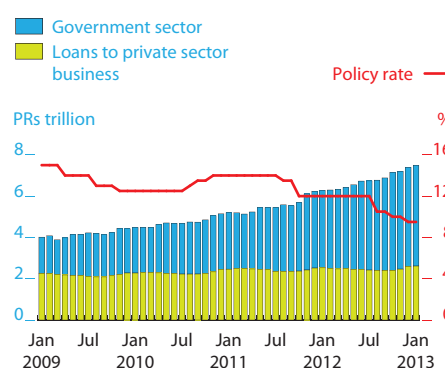
3.20.6 Domestic and external debt



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 6 March 2013).

[Click here for figure data](#)

3.20.7 Banking sector credit



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 6 March 2013).

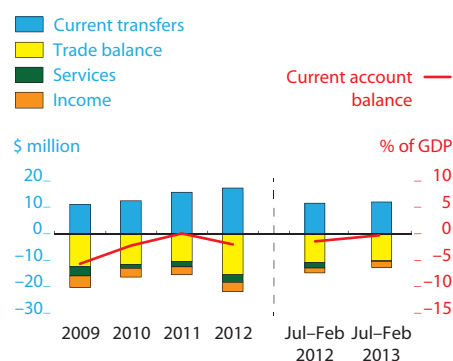
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3.20.1 Selected economic indicators (%)

	2013	2014
GDP growth	3.6	3.5
Inflation	9.0	9.5
Current account balance (share of GDP)	-0.8	-0.9

Source: ADB estimates.

3.20.8 Current account components



Sources: State Bank of Pakistan. Economic Data. <http://www.sbp.org.pk> (accessed 21 March 2013); ADB estimates.

[Click here for figure data](#)

improving energy supply or investment, growth is expected to remain weak at 3.5% in FY2014.

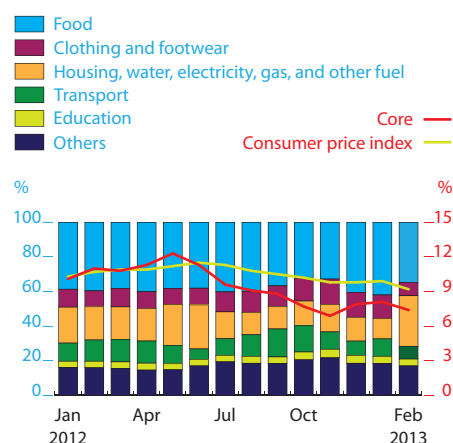
Consumer price inflation continued a downward trend during most of the first 8 months of FY2013 as food price inflation decelerated. However, year-on-year inflation at 7.4% in February 2013 was higher than the year low of 6.9% in November 2012 as food prices moved higher (Figure 3.20.9). Nevertheless, food inflation in this fiscal year is much slower than a year earlier, reflecting improved supply. Core inflation, excluding food and energy, also improved but, at 9.6% in February 2013, remains stubbornly high with many of its subcomponents staying in double digits, reflecting entrenched inflationary pressure in the economy. However, with slower growth in food and energy prices, inflation is expected to average 9.0% in FY2013, or 2 percentage points lower than in the previous fiscal year. On the expectation that there will be no substantive improvement in the country's fiscal and energy imbalances in FY2014, inflation is expected to edge up to 9.5%.

Easing inflation early in FY2013 prompted further reductions in the central bank's main policy rate by a total of 250 basis points, bringing it to 9.5% in December 2012 (Figure 3.20.10). While banks' weighted average rate on new loans in this period fell by about 200 basis points to 11.3%, overarching constraints coming from energy shortages and other uncertainties, such as law and order issues, will limit the impact of interest rate reductions on investment and business conditions in general. A modest increase in lending to private businesses in the first 7 months of FY2013 was mainly for working capital, with the bulk of lending going to textile firms.

A modest surplus in the current account during the first 7 months of FY2013, following inflows of \$1.8 billion from the Coalition Support Fund, reverted to a deficit of \$700 million in February 2013. As disbursements of the same magnitude are not expected during the second half of the year, it is expected that the current account will post a deficit on the order of 0.8% of GDP. Exports contracted by 0.9% during the first 8 months of FY2013, but a 3.5% contraction in imports was four times larger (Figure 3.20.11). Low export growth was largely the result of 2.7% lower textile exports, reflecting the impact of sustained energy shortages, difficulties in meeting production schedules, and slack global demand. The contraction in imports was mostly of food, transportation equipment, and petroleum.

Despite improvement in the current account, net liquid foreign exchange reserves declined further, dropping from \$10.8 billion at the end of June 2012 to \$7.9 billion at the end of February (Figure 3.20.12), reflecting higher debt amortization payments, including payments to the International Monetary Fund (IMF), and lower financial inflows. Low reserves adequacy, at less than 2 months of imports cover as of February 2013, raises concern over external sector sustainability. Pressure on reserves is expected to continue, with an additional \$1.7 billion due to the IMF before the end of FY2013 and \$3.2 billion during FY2014. The financial account was in deficit during the first 8 months of FY2013 (Figure 3.20.13) despite a modest revival in portfolio inflows as foreign direct investment stagnated. The nominal exchange rate depreciated by 4% in the first 8 months of FY2013.

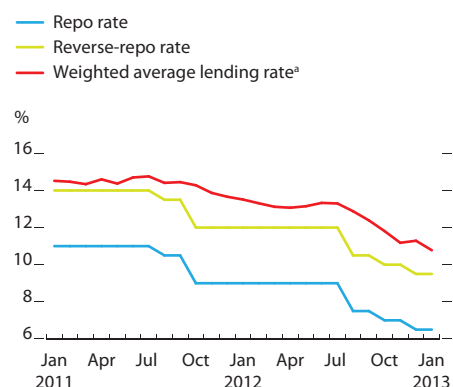
3.20.9 Weighted contribution to consumer price index inflation



Source: State Bank of Pakistan. Economic Data. <http://www.sbp.org.pk> (accessed 5 March 2013).

[Click here for figure data](#)

3.20.10 Interest rates



^a On gross disbursements, the amounts disbursed by banks either in Pakistan rupees or foreign currency against loans during the month. Also includes loans repriced, renewed, or rolled over during the month. In case of running finance, the disbursed amount means the maximum amount received by the borrower at any point during the month.

Sources: State Bank of Pakistan. <http://www.sbp.org.pk>; CEIC Data Company (both accessed 21 March 2013).

[Click here for figure data](#)

3.20.11 Growth in exports and imports



Note: 2013 data is from July 2012 to February 2013.

Source: State Bank of Pakistan. Economic Data. <http://www.sbp.org.pk> (accessed 17 January 2013).

[Click here for figure data](#)

Continued weak export prospects, combined with limited import demand held down by slow domestic growth and relatively stable global prices for oil, support a projection that the current deficit will increase marginally to 0.9% of GDP in FY2014. However, weak capital inflows and large debt repayments, including to the IMF, will put pressure on the official reserves and the exchange rate.

The fiscal outlook is largely unchanged from FY2012. Revenue targets announced with the FY2013 budget are unlikely to be met, as tax receipts have grown by only 12.0% in the first 6 months, well below the 23.7% increase needed to meet budget targets. On the expenditure side, overruns on interest outlays and subsidies are again expected, as subsidy allocations of PRs120 billion have already been exceeded and will reach at least PRs200 billion along with a further buildup of power sector arrears. The deficit for the first half of FY2013 is 2.5% of GDP, including the 0.7% of GDP from the Coalition Support Fund that is the single payment for the year. Given normal quarterly patterns for fiscal balances, the deficit for FY2013 is expected to breach the 4.7% target and is likely to come in at 7.0%–7.5% of GDP, excluding any payments to settle power sector arrears.

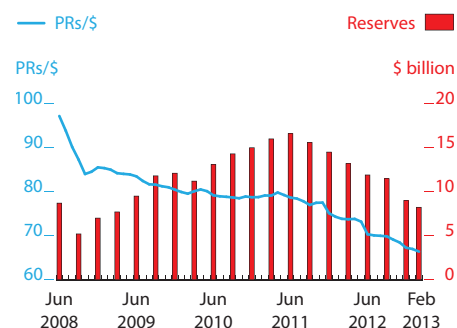
Government bank borrowing continued in the first half of FY2013. The government did acknowledge requirements under the State Bank of Pakistan Act by retiring PRs399 billion of the PRs505 billion borrowed from the central bank during the first quarter of FY2013, before borrowing back PRs183 billion in the second quarter in response to fiscal pressures, thereby breaching the act once again. Large government borrowing from commercial banks requires ever-larger injections from the central bank on a weekly basis to meet banks' liquidity requirements and keep money market rates anchored within central bank policy rates (Figure 3.20.14). Taming inflation would require shrinking these injections, which would require in turn lower government borrowing or else higher lending rates to further crowd out credit to the private sector.

Development challenge—lifting constraints on growth

The economy faces fundamental challenges to growth. The existing pattern of consumption-led growth with falling investment is unsustainable. In this context, macroeconomic sustainability and increasing investment go hand-in-hand with the improved growth prospects necessary to provide adequate employment. Unchanged policies marked by the lack of structural reform, high fiscal deficits, and accommodative monetary policies will mean continued slow growth, excessive inflation, and a weakening balance of payments that drains official reserves. Some drivers of the current situation, such as security challenges, are unlikely to change immediately. However, other factors, such as the energy deficit and the losses run up by public sector enterprises that drain fiscal resources needed for infrastructure development, are more malleable in the near and medium term.

Deterioration in the power sector is the main physical constraint on growth and a major cause of financial and economic instability. Power outages are estimated to cut growth by 2 percentage points annually,

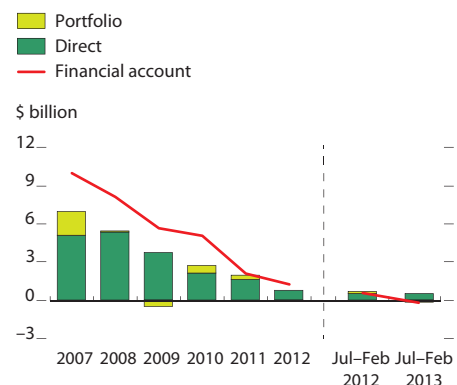
3.20.12 Foreign reserves and exchange rate



Sources: State Bank of Pakistan; CEIC Data Company (accessed 21 March 2013).

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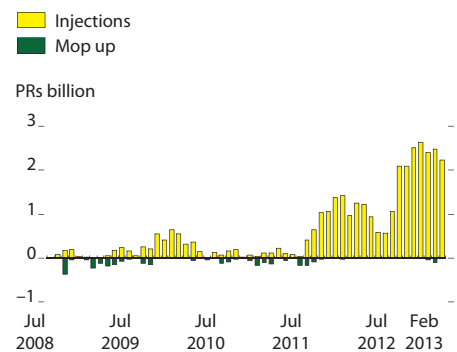
3.20.13 Foreign direct investment, portfolio, and financial account net flows



Source: State Bank of Pakistan. <http://www.sbp.org.pk> (accessed 6 March 2013).

[Click here for figure data](#)

3.20.14 State Bank of Pakistan open market operations



Source: State Bank of Pakistan. 2013. *Statistical Bulletin*. January.

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making it unlikely that Pakistan will be able, without significant reform, to move toward the 7% growth rate needed to generate adequate employment and meaningful poverty reduction. The current environment in the power sector, in which receipts do not cover costs, means that for every unit of power sold there is a large loss that is either covered by a government subsidy or becomes part of the continuously accumulating arrears of the state-owned power companies. Growing arrears, which reached PRs450 billion at the end of December 2012, or about 2% of GDP, constrain the availability of cash needed to operate existing power-generation assets at full capacity. While it will take time to move to a more efficient system for generating, transmitting, and distributing electricity, improvements to collection, adjustments to pricing mechanisms, and improved management could enable higher power generation, lift the financial burden on the budget, and motivate private investment in the sector.

Large loss-making public sector enterprises absorb fiscal resources without any apparent improvement in their operations or financial viability. Explicit subsidies included in the budget for them are limited, as most assistance is in the form of sovereign loan guarantees that require lump sum payouts from the government at crisis points. The end result is the inefficient provision of services at prices that are higher than necessary. The framework for economic growth approved by the government in FY2011 identifies the restructuring of public sector enterprises as a key focus area. Its recent approval of corporate governance rules for public sector enterprises is a step in the right direction, but the rules will need to be rigorously applied in the face of long-standing resistance to change.

Finally, achieving the major challenge of boosting agricultural productivity and strengthening food security requires improving the management, storage, and pricing of water for irrigation. Anecdotal evidence suggests that agricultural productivity could be doubled with appropriate reform. Improved water management is critical to deliver sufficient water to the 80% of farmland in the country that is irrigated.

Pakistan is one of the most water-stressed countries in the world, not far from being classified as “water scarce,” with less than 1,000 cubic meters per person per year. Water demand exceeds supply, which has caused maximum withdrawal from reservoirs. At present, Pakistan’s storage capacity is limited to a 30-day supply, well below the recommended 1,000 days for countries with a similar climate. Climate change is affecting snowmelt and reducing flows into the Indus River, the main supply source. Increases in storage capacity to manage periods of low snowmelt and low rainfall are required, as well as the rehabilitation of the distribution system to reduce losses.